Sri Lanka's Economic Prospects and Challenges[1]
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The Government of Sri Lanka (GSL) finally won its long struggle against the Tamil Tigers last May. As a result, President Mahinda Rajapakse and his United Peoples Liberation Front now enjoy great popularity among the Sinhalese majority. This popularity was reflected in party victories in recent provincial and local elections. Issues of national reconciliation, especially when and how the government will move ahead with its plans to placate Tamil grievances by devolving some political powers to regional governments, remain on the table.

Despite a long-held expectation that the end of the war would bring an economic "peace dividend," the worldwide recession caused economic growth to slump badly in 2009. The economy grew surprisingly well during the 26-year struggle, averaging about 5% in recent years and reaching 8% in 2008. This growth lifted Sri Lanka into the category of lower middle income countries. This year, however, the prospect is for an increase of only 3.5% (latest IMF estimate). Better results are hoped for in 2010 and future years. Although the government has embraced free market policies since the late 1970s, insecurity, war losses, and the commitment of massive resources to the military effort held economic growth down well below its potential. The end of the civil war opens up opportunities for the country to accelerate its development by pressing ahead with needed governmental reforms and revitalizing its private sector.

The global financial crisis has had a serious impact on Sri Lanka. Although the high prices experienced for food and fuel imports experienced in 2008 have eased off, a sharp fall in demand for Sri Lankan exports has caused economic growth to falter this year. The impact of the recession was aggravated by the GSL's permissive fiscal policies, its reliance on short-term external financing, and a struggle to maintain an increasingly overvalued exchange rate. Difficulties in attracting capital from the outside, combined with repeated central bank interventions to defend the exchange rate, caused foreign exchange reserves to fall to a low level at the beginning of 2009. A likely financial crisis was averted in May when a $2.6 billion loan from the International Monetary Fund was agreed to -- over the opposition of the governments of the United States, Britain, and France, all of which expressed concern over Sri Lanka's human rights record and skepticism that the GSL would carry out reforms. During the second half of 2009, reserves began to recover.

Maintenance and resettlement of 280,000 or more Internally Displaced Persons (IDPs) interned in camps following the end of hostilities is a current humanitarian problem. International relief organizations, Western governments, and the media have criticized the GSL's internment policy and its implementation. Few IDPs have been allowed to return to their homes so far and with the recent onset of seasonal rains flooding deaths have been reported in some camps. Addressing the reconstruction needs of the areas affected by the conflict will require a substantial effort over the next several years. A high-level task force appointed by the government is conducting a comprehensive needs assessment. The IMF estimates that

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reconstruction may cost approximately 1% of GDP each year for many years to come, depending on the productivity of the reconstruction projects and the terms of donor financing.

The GSL is carrying out development programs in the northern and eastern regions with USAID and World Bank assistance. These parts of the country have been neglected by the government for many years and have experienced less economic growth than the western and southern regions. The new programs try to create employment and training opportunities for at-risk youth, including ex-combatants. In the near future, demobilization of the bloated Sri Lankan armed forces will pose a major employment challenge.

Inflation, which was high last year, largely because of high import prices, has fallen back into the single-digit range this year. According to the latest IMF appraisal, inflation is likely to average 4.9% over the year as a whole but accelerate toward the end of the year and reach 8.6% in 2010. High inflationary expectations among the public this may fuel wage demands and underlying inflationary pressures next year. In 2010 the weakening currency and recovering world prices for commodities (especially oil) will also exert upward pressure on the price of imported goods, while tax increases will add another inflationary element to the mix. In addition, revived economic growth may test supply constraints, posing further inflationary challenges.

Efforts are being made to reduce the GSL's large fiscal deficit. The government hopes to cut the deficit, which has averaged about 8% of GDP for several years, to 7% in 2010 and 5% by 2011 through a combination of tax increases and expenditure cuts. It also hopes to bring the accounts of the two largest state enterprises (the Ceylon Electricity Board and the Ceylon Petroleum Corporation) into balance by 2011. But Sri Lanka faces severe fiscal challenges. The scale of these problems may force the government to undertake limited disposals of its stakes in state-owned enterprises in 2010, despite the strong opposition to privatization that exists within the UPFA. The Economist Intelligence Unit (EIU) expects defense spending to fall slightly in 2010 as security improves but remain elevated owing to the long-term nature of munitions-purchase contracts. It predicts that the fiscal deficit (excluding grants and privatizations) will average 9.1% of GDP in 2009-2010. Sri Lanka's growing reliance on debt issuance at commercial rates means that public debt will continue to become more expensive to service, despite the concessionary terms of the IMF loan.

The Central Bank of Sri Lanka has found it easier to win foreign funding since agreeing to the IMF support package. In August it was able to borrow $190 million in dollar-denominated two-year bonds from domestic and foreign commercial banks. According to the Central Bank, the money will be used to repay $175 million of maturing bonds. The CBSL governor confirmed in August that foreign investors had recently paid around $875 million to acquire Sri Lanka rupee-denominated four- and six-year government debt. This, coupled with a $322 million inflow associated with the IMF loan, helped to boost the island's gross official reserves to $2.3 billion by August 17.

There are substantial risks to the program that the GSL is carrying out under the tutelage of the IMF. Achieving the goals of the program will require a great deal of government commitment to implementing politically difficult measures, particularly for the budget and the exchange rate. At the same time, the end of the war should have a positive economic impact.

Halting progress is being made to deal with a shortage of power. Sri Lanka's electric power sector is heavily dependent on hydroelectric generation and thus remains vulnerable to weather conditions. The Ceylon Electricity Board, the state-owned monopoly power supplier, prefers to use the cheaper electricity generated by hydropower sources over the more expensive thermal power that is largely provided by private operators. Dry weather conditions caused a sharp contraction in hydropower generation in the first half of 2009. Projects to build power plants that would achieve greater economies of scale and use cheaper fuel have encountered numerous obstructions, including environmental concerns, land disputes, and financing problems. Renewed efforts are being made by the current administration.

Sri Lanka needs to increase the competitiveness of its exports. In the view of the IMF, this will require a depreciation of the exchange rate. An overvalued rupee has damaged Sri Lanka's external competitiveness, as evidenced by the steady decline in its export market share. Without a currency depreciation, Sri Lanka will face stiff competition once a global recovery begins to emerge from other competing countries which have already adjusted, particularly for garment exports.

Some exchange rate depreciation is expected this year and next. Sri Lanka's low foreign exchange reserves limit the government's ability to support the value of the Sri Lanka rupee, but the IMF's assistance package should ease this constraint in 2009-2010. Continuing currency depreciate may thus be modest. Strong inflows of remittances and concessional lending will continue to provide support, and large interest rate differentials with OECD countries will draw in portfolio investment. If disagreements between the GSL and the IMF lead the Fund to cut off its support to Sri Lanka, however, the rupee could lose value much more quickly than currently expected. Whether the depreciations will be sufficient to restore Sri Lanka's competitiveness remains to be seen.

Tourism is reviving rapidly. The end of the civil war has resulted in a dramatic increase in the number of tourists visiting Sri Lanka. Arrivals since June have been up sharply over 2008. India and Germany have been among the island's leading sources of arrivals.

Commodity export prospects are less good. Sri Lanka may lose favored access to the EU market as a result of European disapproval of its human rights record**.** "GSP Plus" status has provided the country with valuable export earnings in the European market in recent years. A recent report commissioned by the EU found that Sri Lanka failed to honor important human rights commitments and is therefore ineligible for continued GSP Plus status. A final decision is expected this month.

Business regulation in Sri Lanka requires simplification and improvement. Sri Lanka ranked 110th out of 183 countries on the ease of doing business index in the World Bank's just-released *Doing Business 2010.* This ranking was down from 97th in 2009, reflecting the fact that other countries are reforming their business environments faster than Sri Lanka, which the Bank credits with just one reform in the past year. Especially weak areas highlighted by the recent report are dealing with construction permits (168th), paying taxes (166th), registering property (148th), and enforcing contracts (137th). Sri Lanka performed somewhat better in certain other areas: starting a business (41st); closing a business (45th); and trading across borders (65th). According to the World Bank, getting permission to build a warehouse in Sri Lanka involves 22 separate procedures, takes 214 days, and costs more than 14 times GNI per capita. Similarly, taxes on business are reported to be highly burdensome, taking 63.7% of profits and involving 62 payments per year, which require 256 hours of work for compliance. These and other areas of business regulation clearly need attention if Sri Lanka hopes to attract significant amounts of private investment, either foreign or domestic.

Action to restore fiscal balance should not harm the poor. According to the World Bank, although only 14% of the Sri Lankan population was living in severe poverty (less than $1.25 a day per capita in international purchasing power) in 2002, a very large number (40%) were living on less than $2 a day. The recession and the displacement of large numbers of people in the north and east are having significant social consequences for the poor and near-poor. For this reason, the needed fiscal adjustments should protect expenditures on social transfers to Sri Lanka's most vulnerable. The main safety net is Samurdhi, a cash transfer program that addresses chronic poverty and channels disability payments. The system also provides limited social welfare and care services as well as disaster relief to displaced persons.

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